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The Reciprocal Duty of Good Faith Negotiations in Chapter 9 Bankruptcies

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Introduction

The Bankruptcy Code states that municipalities may only proceed under chapter 9 of the Bankruptcy Code if, among other things, they are specifically authorized to do so by their respective state law.[1] As a result, municipal bankruptcies are governed by both the Bankruptcy Code and the state law of the relevant municipality. Under the Bankruptcy Code, the good faith of the parties involved is of primary importance due to its role in the approval or rejection of a debtor's petition for chapter 9 bankruptcy protection. Given the fact that a successful petition has the ability to significantly alter the fortunes of municipal debtors and creditors alike, the meaning of good faith matters to all parties involved.[2] Alternatively, under state law, the good faith of the parties matters only to the extent that it is dispositive under state law.

Given the importance of good faith in municipal bankruptcies, this Article will explain the meaning of good faith in the context of a chapter 9 case. Part I will examine the case law

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[1] 11 U.S.C. §109(c)(2)

[2] Paul R. Glassman, *A Practical Guide to Chapter 9 Municipal Bankruptcy* (2011) (noting that among other things a successful petition "operates to stop all collection actions against the debtor and its property …. 11 U.S.C. § 362(a)." Permits the debtor "to borrow on a priority basis, secured by liens on the debtor's property. 11 U.S.C. § 364(c)-(d)." Permits the debtor "to breach unperformed contract obligations and limit its damage liability … subject to court approval. 11 U.S.C. § 365.)

related to the concept of good faith as it pertains to municipal bankruptcies under the Bankruptcy Code. Part II will examine the decisions of *In Re City of Stockton*, and *In re City of Detroit*, to determine how the state laws of California and Michigan have incorporated the concept of good faith, and how bankruptcy courts in these states interpret the concept of good faith under the Bankruptcy Code. Part III will explain the implications that the case studies addressed in Part II will have on municipal bankruptcies going forward.

Part I: Good Faith under the Federal Bankruptcy Code

Despite the fact that good faith plays a determinative role regarding chapter 9 protection, in section 109(c)(5)(B), the Bankruptcy Code does not define good faith.[3] Thus, the only way to determine its meaning is from its context and applicable case law.[4] Section 109(c) describes which entities can utilize chapter 9 protection. The section dictates that an entity can be a debtor under chapter 9 only if it meets five requirements.[5] The fifth requirement, section 109(c)(5) can be satisfied in one of four different ways. The second of these four ways, section 109(c)(5)(B), requires that the entity have "negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such

[3] *In re* Brown, 88 B.R. 280, 284 (Bankr. D. Haw. 1988); *In re* Setzer, 47 B.R. 340, 344 (Bankr. E.D.N.Y. 1985).
[4] Bankr. L. Rep. P 67576 (C.C.H.), 1980 WL 581783.
[5] 11 U.S.C. § 109(c)(1-5) states that "[a]n entity may be a debtor under chapter 9 of this title if and only if such entity: (1) is a municipality; (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter; (3) is insolvent; (4) desires to effect a plan to adjust such debts; and (5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (C) is unable to negotiate with creditors because such negotiation is impracticable; or (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.")

entity intends to impair under a plan in a case under such chapter."[6]

In the context of section 109(c)(5)(B), courts have held that debtors' duty to negotiate in good faith with creditors is not met by mere good faith negotiations alone.[7] Rather, relying on legislative history and statutory context, courts have held that the negotiations must be in regards to a proposed plan for the adjustment of the municipal debtor's debts.[8]

For example, in *In re City of Vallejo*, the court held that the ambiguous phrase, "negotiated in good faith with creditors," when interpreted in the context of the statute as a whole, "requires negotiations with creditors revolving around a proposed plan."[9] Similarly, in *In re Cottonwood Water & Sanitation District*, the court held that "the strong legislative record indicat[ed] that section 109(c)(5) . . . insures that the creditors have an opportunity to negotiate concerning a plan."[10] Despite the fact that good faith negotiations must revolve around a proposed plan, courts have emphasized that the plan around which good faith negotiations must revolve, need not be a comprehensive plan. Rather an "outline or a term sheet of a plan which designates classes of creditors and their treatment will suffice."[11]

The requirement of good faith negotiations is a reciprocal requirement that is binding on both the municipal debtor and its creditors.[12] While section 109(c)(5)(B) is directed towards municipalities, it has been found to imply a duty to negotiate in good faith on the municipality's

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[6] *In re* City of Stockton, Cal., 493 B.R. 772, 777 (Bankr. E.D. Cal. 2013)
[7] *See*, *eg*., In re City of Vallejo, 408 B.R. 280, 297 (B.A.P. 9th Cir. 2009); In re Cottonwood Water & Sanitation Dist., Douglas Cnty., Colo., 138 B.R. 973, 978-79 (Bankr. D. Colo. 1992)
[8] *Id.*
[9] *In re* City of Vallejo, 408 B.R. 280, 297 (B.A.P. 9th Cir. 2009)
[10] *In re* Cottonwood Water & Sanitation Dist., Douglas Cnty., Colo., 138 B.R. 973, 978-79 (Bankr. D. Colo. 1992)
[11] *In re* New York City Off-Track Betting Corp., 427 B.R. 256, 274 (Bankr. S.D.N.Y. 2010) (quoting In re City of Vallejo, 408 B.R. at 297)
[12] *In re* City of Stockton, Cal., 493 B.R. 772 (Bankr. E.D. Cal. 2013)

creditors as well.[13] For example, in the case of *In re City of Stockton*, municipal creditors, who had refused to respond to Stockton's proposed plan of adjustment, objected to the City of Stockton's ("Stockton") petition for chapter 9 protection. The creditors argued that the good faith negotiations requirement of 109(c)(5)(B) applied only to Stockton.[14] In response the court noted that "[j]ust as it takes two dancers to tango, good faith negotiations contemplate reciprocity."[15] Because the objectors had refused to respond to Stockton's proposed plan of adjustment, the court found that Stockton had fulfilled its good faith negotiations requirement under section 109(c)(5)(B).[16] Thus, the duty to negotiate in good faith, concerning a proposed plan of adjustment, is a reciprocal duty that both the municipal debtor and its creditors must fulfill.

Part II: Case Studies: Good Faith as Applied in California and Michigan

Under section 109(c)(2) of the Bankruptcy Code, a municipality may only file for chapter 9 protection under the Bankruptcy Code if it "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law."[17] California and Michigan both authorize their municipalities to file for chapter 9 protection under the Bankruptcy Code provided the municipality complies with certain processes.[18]

California requires its municipalities to undergo a neutral evaluation process in which both the municipality and "all interested parties" are required to negotiate in good faith. Michigan sets forth a similar neutral evaluation process in which "all interested parties" are to negotiate in good faith. Thus, both States' neutral evaluation processes require a reciprocal duty

[13] *Id.*
[14] *Id.* at 793
[15] *Id.*
[16] *Id.*
[17] 11 USC 109(c)(2)
[18] Cal. Gov't Code ß 53760.3; Mich. Comp. Laws Ann. § 141.1565

of good faith negotiations. However, in Michigan the neutral evaluation process is one of four processes the municipality has to choose from in order to be eligible for chapter 9 protections. The recent decisions *In re City of Stockton*, from California, and *In re City of Detroit*, from Michigan, provide insight into the obligations that the requirement of good faith negotiations, under both the Bankruptcy Code and the neutral evaluation processes, imposes on municipalities and other interested parties.

A. *In re City of Stockton*

In the case of *In re City of Stockton*, the court interpreted both section 109(c)(5)(B) of the Bankruptcy Code and the California enabling statute as requiring good faith negotiations from both the municipal debtor, Stockton, and its creditors. Prior to petitioning the court for chapter 9 protection, Stockton presented a proposed adjustment plan to its creditors describing how it would deal with the affected parties. The proposed plan included a promise by Stockton to eventually make whole two of its capital creditors, National Public Finance Guarantee Corporation ("National Public Finance Guarantee") and Assured Guaranty Ltd. ("Assured Guaranty"), both municipal bond insurers. However, the proposed plan did not provide for Stockton to service its bond debt for varying amounts of time. Furthermore, the proposed plan did not impair any of Stockton's pension obligations to the California Public Employees' Retirement System ("CalPERS"). In response to this proposal, the two capital creditors refused to negotiate unless Stockton include in its plan an impairment of its pension obligations to the CalPERS. When Stockton filed for bankruptcy under chapter 9 protection, National Public Finance Guarantee, Assured Guaranty, and two other capital creditors objected, alleging, that Stockton had failed to negotiate in good faith, which was required under both the Bankruptcy Code and the California enabling statute.

The court held that Stockton had met its requirement to negotiate in good faith under both the California enabling statute and the Bankruptcy Code. The court noted that California defines the duty of "good faith" as "participation by a party in the neutral evaluation process with the intent to negotiate toward a resolution of the issues that are the subject of the neutral evaluation process."[19] The court further noted that California's neutral evaluation statute imposes this duty upon both the public entity and all 'interested parties.'[20] Because both National Public Finance Guarantee and Assured Guaranty refused to negotiate unless Stockton impaired the CalPERS obligations, the court found that they had failed in their obligation to negotiate in good faith. Indeed, the court noted that "the objectors, having adopted the posture of a stone wall by refusing seriously to negotiate, will not now be heard to complain about the negotiating behavior of their counterparty."[21] The court found that Stockton had met its duty to negotiate in good faith under California's enabling statute because Stockton's creditors had failed to fulfill their *reciprocal* duty to negotiate in good faith, as per California's enabling statute.

The court likewise found that Stockton had met its good faith negotiations duties under section 109(c)(5)(B) of the Bankruptcy Code. In contrast to the California enabling statute, section 109(c)(5)(B) only explicitly places the good faith negotiation requirement on the municipality. As a result, National Public Finance Guarantee and Assured Guaranty asserted at trial "that [section] 109(c)(5)(B) good faith is a one-way obligation applicable to [Stockton] but *not* to the objectors themselves."[22] In response to this argument, the court stated that "good faith negotiations contemplate reciprocity" and therefore, "a municipality's section 109(c)(5)(B) good

[19] *In re* City of Stockton, Cal., 493 B.R. 772, 785 (Bankr. E.D. Cal. 2013) (quoting Cal. Gov't Code § 53760.1(d)).
[20] Cal. Gov't Code § 53760.3(o) states that "the local public entity and all interested parties participating in the neutral evaluation process shall negotiate in good faith"
[21] *In re* City of Stockton, Cal., 493 B.R. at 786.
[22] *Id*. at 793.

faith negotiation obligation is satisfied with respect to any class of putatively impaired creditors that declines to respond in good faith to a good faith proposal by the municipality."[23] Although section 109(c)(5)(B) only explicitly places the good faith negotiation requirement on the municipality, the court interpreted it as imposing a *reciprocal* duty of good faith negotiations on municipal creditors, like California's enabling statute. Under this interpretation, Stockton's good faith proposal fulfilled its good faith negotiations duty under section 109(c)(5)(B) when National Public Finance Guarantee and Assured Guaranty refused to respond in good faith.

B. *In re City of Detroit*

The United States Bankruptcy Court for the Eastern District of Michigan approved the City of Detroit's ("Detroit") petition for chapter 9 protection, despite finding that it had failed to negotiate with its creditors in good faith. The court held that Detroit's failure to negotiate in good faith was irrelevant, as good faith negotiations were not required under the relevant state law and good faith negotiations were impractical according to section 109(c)(5)(C) of the Bankruptcy Code.

In the years leading to its chapter 9 petition, Detroit had taken a number of steps to address its financial distress.[24] In response to a finding that Detroit faced a "financial emergency," the City of Detroit decided to appoint Kevyn Orr as Detroit's emergency manager.[25] Orr presented Detroit's creditors with a proposal on June 14, 2013, which described "across the board" cuts to creditor obligations.[26] In response, Detroit's creditors, of which there were over 150, including "(a) [Detroit's] debt holders; (b) the insurers of this debt; (c) [Detroit's] unions; (d) certain retiree associations; (e) the Pension Systems; and (f) many individual

[23] *Id.*
[24] In re City of Detroit, Mich., 504 B.R. 97, 117-22 (Bankr. E.D. Mich. Dec. 20, 2013)
[25] *Id*. at 125.
[26] *Id*. at 174-75.

bondholders,"[27] that refused to respond.[28] A little over a month later, Detroit filed for chapter 9 protection. Detroit's creditors objected alleging, among other things, that the City of Detroit did not negotiate with them in good faith.[29]

The court did not examine whether Detroit had met its good faith negotiation obligations under Michigan's enabling statute because good faith negotiations are not required under the provision of the enabling statute under which Detroit had chosen to proceed. Michigan's enabling statute grants local governments four options from which they can choose in the event they are faced with a "financial emergency"[30]: (1) the consent agreement option[31]; (2) the emergency manager option[32]; (3) the neutral evaluation process option[33]; and (4) the chapter 9 bankruptcy protection option.[34] Detroit chose to proceed under the emergency manager option. While the neutral evaluation process option requires all interested parties to negotiate in good faith, the emergency manager option has no such requirement. Because Detroit opted to appoint an emergency manager, and decided to forgo the neutral evaluation process, the court did not determine whether Detroit had engaged in good faith negotiations under Michigan state law.

With respect to Detroit's duty to negotiate in good faith under bankruptcy law, the court held that Detroit had failed to meet this duty, but granted it chapter 9 protection as it found that

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[27] *Id*. at 126.
[28] *Id*. at 174.
[29] *Id*. at 112.
[30] Mich. Comp. Laws Ann. § 141.1547 (stating that "upon the confirmation of a finding of a financial emergency under section 6, the governing body of the local government shall … select 1 of the following local government options to address the financial emergency: (a) The consent agreement option pursuant to section 8.2 (b) The emergency manager option pursuant to section 9.3 (c) The neutral evaluation process option pursuant to section 25.4 (d) The chapter 9 bankruptcy option pursuant to section 26).
[31] *Id.* § 141.1548.
[32] *Id.* § 141.1549.
[33] *Id.* § 141.1565.
[34] *Id.* § 141.1566.

good faith negotiations would have been impractical. The court made its determination upon consideration of three factors:

> First, the greater the disclosure about the proposed bankruptcy plan, the stronger the debtor's claim to have attempted to negotiate in good faith….
>
> Second, the municipality's need to immediately disclose classes of creditors and their treatment in the first communication will depend upon how material that information would be to the creditor's decision about whether to negotiate
>
> Third, the creditor's response, and the amount of time the creditor has had to respond, may also be factors.[35]

In its analysis of the negotiations, or lack thereof, the court noted that the first factor weighed against Detroit's argument that it had negotiated in good faith with its creditors. Indeed, the court noted that while the municipality met with creditors and supplied them with a 128-page document, very little of the document dealt with the proposed plan for restructuring. In describing the content of Detroit's proposal, the court said, "[c]haritably stated, the proposal is very summary in nature … [and] is simply [insufficient] for creditors to start meaningful negotiations"[36] Likewise, the court stated that the third factor also weighed against Detroit's argument that it had negotiated in good faith. Because Detroit included in its proposal a calendar, the court was able to determine that the "calendar was very tight and it did not request counter-proposals or provide a deadline for submitting them."[37]

In addition to the three-factor test, the court articulated two additional factors that convinced it that Detroit's negotiations were conducted in bad faith. First, Detroit's misrepresented to its creditors of the nature of the meetings it was holding with the creditors. Detroit indicated to the creditors that the meetings they were having were not negotiations. In

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[35] *In re* City of Detroit, Mich., 504 B.R. 97, 174 (Bankr. E.D. Mich. Dec. 20, 2013) (quoting Mendocino Coast, 2013 WL 5423788, at *8–9)
[36] *Id*. at 175.
[37] *Id.* at 176

addressing this fact, the court noted that "[Detroit] simply cannot announce to creditors that meetings are not negotiations and then assert to the [c]ourt that those same meetings amounted to good faith negotiations."[38] Second, the court noted the manner in which the meetings took place weighed against Detroit. Because the meetings were more "presentational," and "gave little opportunity for creditor input or substantive discussion."[39] The lack of "back-and-forth" between Detroit and its creditors, and the presentational style of the meetings weighed against a finding that Detroit had negotiated in good faith. Despite finding that Detroit had failed to engage in good faith negotiations with its creditors, the court granted Detroit chapter 9 protection because it met the alternative requirement of section 109(c)(5)(C), which allows a municipality to be a chapter 9 debtor if negotiation with the creditors is "impractical."[40]

Part III: Implications

The implications of the above case analyses are four-fold. First, as the *In re City of Stockton* case makes clear, the California enabling statute imposes a *reciprocal* duty on the municipal debtor and its creditors to negotiate in good faith throughout the neutral evaluation process. The municipal debtor is required to present a good faith proposal to its creditors and, if it has done so, its creditors are required to respond in good faith.[41]

Second, due to the similarity of the Michigan statute setting forth the neutral evaluation process to its California counter-part,[42] it is likely that a Michigan court would hold that the

[38] *Id*.
[39] *Id*.
[40] *Id*. at 176-80.
[41] *See In re* City of Stockton, 493 B.R. 772, 785 (Bankr. E.D. Cal. 2013) (stating that "the California statute imposes the good faith negotiation requirement on all interested parties, including the objectors").
[42] *See* Mich. Comp. Laws Ann. § 141.1565 ("The local government and all interested parties participating in the neutral evaluation process shall negotiate in good faith"); *Cf,* Cal. Gov't Code

requirements articulated by the *Stockton* court would be imposed on municipal debtors and creditors. However, as the *Detroit* decision, shows, Michigan's enabling statute provides a debtor municipality with three alternatives to the neutral evaluation process, which do not impose good faith negotiations on the debtor or the creditor.[43]

Third, section 109(c)(5)(B) of the Bankruptcy Code, like the neutral evaluation processes of California and Detroit, imposes a *reciprocal* duty to negotiate in good faith on both the municipal debtor and its creditors.[44] Thus, even in the event that a state enabling statute does not require good faith negotiations, the Bankruptcy Code will require such negotiations from all parties.

Last, in determining whether negotiations initiated by the debtor municipality satisfy its requirement of good faith negotiations under section 109(c)(5)(B) courts will take into account the following five factors: (1) the disclosure provided by the municipality regarding the proposed plan; the extent to which the disclosure of the classes of creditors and their treatment is material to the creditor's decision about whether to negotiate; (3) the amount of time the creditor has to respond; (4) whether the municipality misrepresented the nature of the discussions/negotiations; and (5) whether the format of the meetings was presentational or conversational. If a court finds, based on these five factors, that the negotiations initiated by the municipality do not satisfy the requirement of good faith negotiations under section 109(c)(5)(B), the municipality's creditors will not be required to respond.

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§ 53760.3 ("The local public entity and all interested parties participating in the neutral evaluation process shall negotiate in good faith").

[43] Mich. Comp. Laws Ann. § 141.1547.

[44] *See In re City of Stockton*, 493 B.R. at 793 (stating that "as a matter of law, a municipality's §109(c)(5)(B) good faith negotiation obligation is satisfied with respect to any class of putatively impaired creditors that declines to respond in good faith to a good faith proposal by the municipality").

Conclusion

The good faith requirements articulated in the bankruptcy code are vague, and are not defined by the Bankruptcy Code. However, case law indicates that as the term is used in section 109(c)(5)(B) the municipality seeking chapter 9 protection must negotiate with the interested parties regarding a proposed plan for the adjustment of debts. While courts have not required a comprehensive plan, some sort of outline is required. In addition, this duty to negotiate in good faith does not apply *only* to municipal debtors. Rather, the duty to negotiate in good faith is a *reciprocal* duty that is binding on both the municipal debtor and its creditors. Thus, the bankruptcy court in the case of *In re City of Stockton* held that when the municipal creditors refused to negotiate with Stockton, they not only breached their duty of good faith negotiations under California's neutral evaluation process, but had also breached this duty under the Bankruptcy Code. As a result, the *Stockton* court approved petition for chapter 9 protection.

The bankruptcy court in the case of *In re City of Detroit*, did not rule on the good faith requirement under Michigan's neutral evaluation process. The court did, however, analyze the good faith requirement under section 109(c)(5)(D), and relied on a three-factor test in determining whether the debtor municipality had satisfied the good faith negotiations requirement. The court noted that two of the factors, the extent of Detroit's disclosure of the plan to its creditors, and the amount of time given to the creditors to respond to the plan weighed against Detroit's contention that it negotiated in good faith. Furthermore, the court noted that Detroit's misrepresentation of the meetings and their presentational style indicated that it had not engaged in good faith negotiations with its creditors.

Overall, the notion of good faith, in the context of a petition for chapter 9 protection, is ambiguous. However, case law provides some guide in navigating the requirements of good faith in the context of chapter 9 bankruptcies.